



Business Insurance

Retain, Reward, and Recruit



inside front cover blank

Table Of Contents

- Business Insurance:
An Introduction 2

- Qualified Plans v.
Non-Qualified Plans 2

- Advantages of Non-Qualified
Deferred Compensation 2

- Fundamentals of Non-Qualified
Deferred Compensation 5

- Funding Options for Non-Qualified
Deferred Compensation Plans 6

- Types of Non-Qualified
Executive Benefit Plans 7

- Other Business Insurance
Applications 11



Business Insurance: An Introduction

People commonly think of life insurance as a personal resource used to protect their families from the financial impact of the loss of a loved one. However, there are many ways that life insurance can benefit business owners and their employees. Businesses may use life insurance to provide benefits to their employees, to protect themselves from the loss of a key person, or to plan for the continuation of the business should one of its owners pass away. This guide will review the benefits and types of arrangements that are commonly used in the business world.

Qualified Plans v. Non-Qualified Plans

There are two types of retirement plans that can be used in the business insurance marketplace – qualified and non-qualified plans. The IRS identifies both of these plans as deferred compensation plans and each has advantages and disadvantages depending on the needs of the business.

Qualified Plans	Non-Qualified Plans
Must include all eligible participants in plan design	Can be selective
Must meet ERISA reporting requirements	No onerous reporting requirements
Employer gets tax deduction for contributions	No tax deduction until benefits are paid
Contributions protected from creditors	Assets subject to claims of corporate creditors

Non-qualified plans can be used as a supplement to a qualified plan such as a 401(k) plan to provide key, highly compensated employees with a source of supplemental retirement income.

Advantages of Non-Qualified Deferred Compensation

Retain, Reward, and Recruit

In today's competitive job market, employers need to offer extra incentives to employees. One of the primary reasons that companies establish non-qualified executive benefit plans is to retain, reward, and recruit key employees. These plans can have minimal cost to the employer and can help key executives supplement their qualified plan savings. Non-qualified plans are generally not subject to the same tax and labor law requirements as qualified plans and can be offered to select employees.

Economic Growth and Tax Relief Reconciliation Act (EGTRRA)

Over the past 20 years major tax legislation put caps on the amount of compensation that may be used to determine retirement benefits for highly compensated individuals. The EGTRRA legislation which became law passed on June 7, 2001, changed this. Over the next nine years, the limits will increase and be adjusted in increments of \$1,000 - \$5,000 when applicable. However, these limits will revert back to 2001 limits in 2010 if the bill is not extended. The table on the next page reviews the limits for 2002.

Employee Benefit Limits 2002

"Top Paid Group" Highly Compensated Employee Definition (Section 414(q) (1) (b))	\$90,000
Defined Contribution Limits (Section 415)	\$40,000/100% compensation
Maximum 401(k) Contribution Amount	\$11,000
Maximum Contribution to Qualified Plans for Tax-Exempt Organization (Section 457 (b))	\$11,000
Defined Benefit Amount Limit (Section 415 (b))	\$160,000
Limit on Compensation for Qualified Plans	\$200,000

Source: www.plansponsor.com

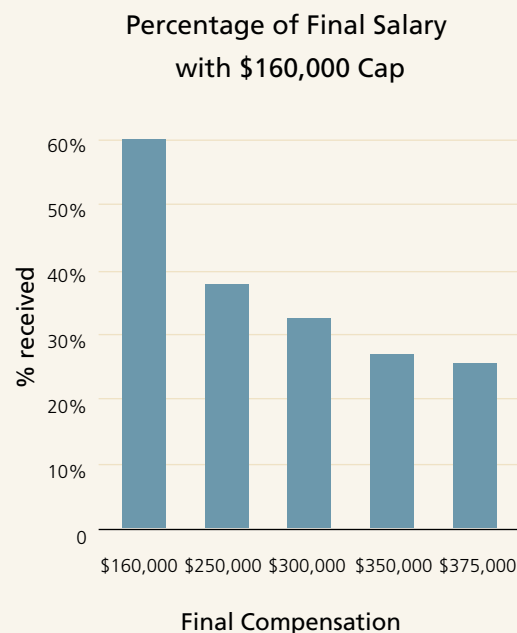
Reverse Discrimination

Even though the 2001 tax law has increased qualified plan contributions limits, top executives often encounter "reverse discrimination" when they are saving for retirement. Defined Benefit Plans usually provide employees with at least 60% of their final three-year average salary and incentive income in retirement. However, highly compensated employees whose average income exceeds the qualified plan limits will eventually receive less than 60%. These caps limit the amount of contributions to 401(k), 403(b), and 457 plans to \$11,000 in 2002; and limit the maximum compensation level to calculate distributions from a defined benefit plan to \$160,000 and a defined contribution plan to \$200,000 in 2002.¹ Therefore, someone

with an average income that exceeds the \$160,000 defined benefit cap loses income because their retirement benefits are calculated based upon \$160,000 instead of their actual income. For example, someone whose income is \$375,000 is only going to have 26% of his or her final salary in retirement. Let's look at an example:

EXAMPLE

Janet Buckfield, Executive Vice President of Mountain View Industries, receives annual compensation of \$375,000. Her employer provides its employees 60% of the average of their final three years compensation in retirement. But, because of qualified plan limitations she will receive \$96,000 (60% of \$160,000) a year in benefits. This is only 26% of her final compensation compared to the 60% that most employees receive.



Social Security

Highly compensated executives are also faced with “reverse discrimination” when it comes to Social Security payments. Even though Social Security was not intended as a way for workers to maintain their pre-retirement standard of living, it does account for part of the benefits package. In the case of highly compensated individuals, this usually amounts to less than 15% of the entire package. Another factor to consider is that the age that executives will be eligible for full benefits from Social Security has increased from age 65 to age 67.

Age to Receive Full Social Security Benefits

Year of Birth	Full Retirement Age
1937 and earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

The earliest a person can start receiving “reduced” Social Security retirement benefits will remain age 62.
Source: www.ssa.gov/retire2/agereduction.htm

Social Security Benefits for 2002

Maximum Earnings	\$84,900
Maximum Benefit in 2002 for individual retiring at age 65	\$19,920/year or \$1,660/month
Tax Rate	
Medicare	1.45%*
Social Security	6.20%
TOTAL	7.65%

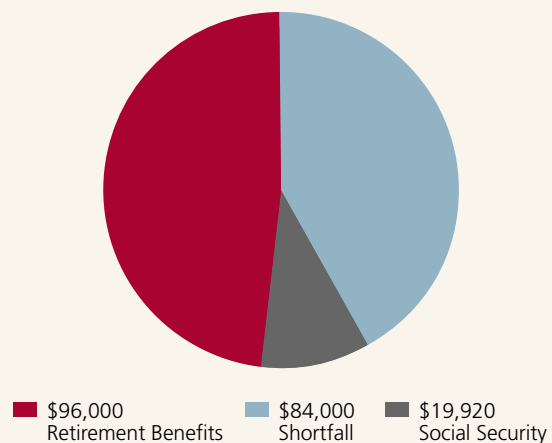
Source: www.ssa.gov
* unlimited wage base

Non-Integrated Plans

Employers may set up non-integrated plans. These are plans which are not coordinated with Social Security benefits. Thus, an employee may receive full benefits up to the limit in addition to Social Security benefits. In an integrated plan, Social Security may be used to offset retirement benefits by including it in the total benefits calculation. Let’s look at an example:

EXAMPLE

George McDonald, an Executive Vice President, age 65, is retiring from Mountain View Industries. He has been with the company for over 25 years. His final three-year average annual salary and incentive compensation was \$300,000. He is eligible for maximum Social Security benefits. Mountain View Industries pays its employees 60% of their final compensation, not integrated with Social Security. George anticipates receiving \$180,000 (60% of \$300,000) a year plus his Social Security benefits of \$19,920 for a total of \$199,920. But, because the maximum compensation amount for computing the annual benefit is \$160,000, George will receive only \$115,920 annually (60% of \$160,000 is \$96,000 plus Social Security benefits of \$19,920). Due to qualified plan restrictions, George will have a shortfall of \$84,000, even with Social Security benefits.





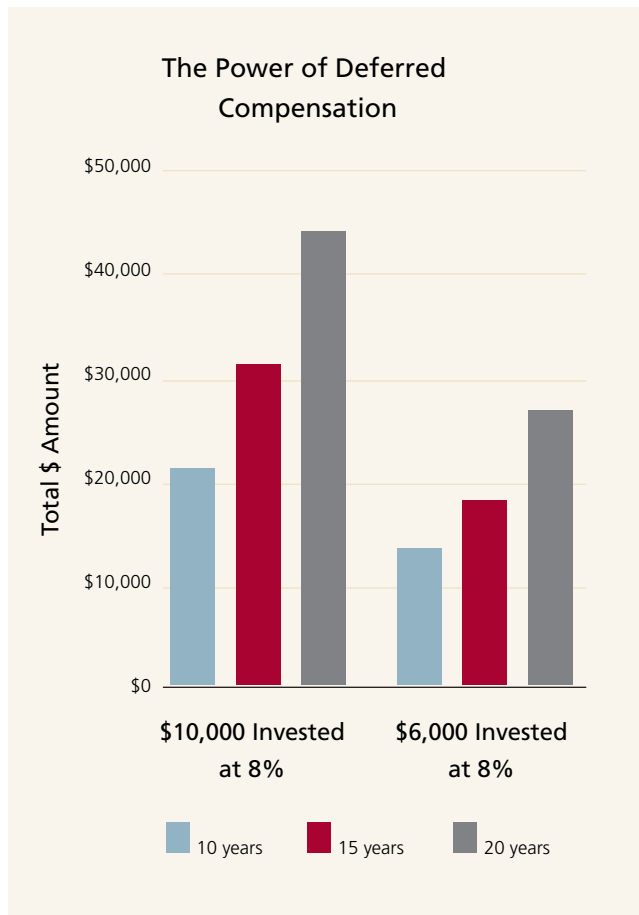
Fundamentals of Non-Qualified Deferred Compensation

Executive Benefit Planning

Executive benefit plans are arrangements between an employer and an employee which provide the key employee with a form of supplemental retirement income or other benefits in addition to standard qualified plans, such as 401(k) plans. These plans may not be subject to the same tax and labor law (ERISA) requirements as qualified plans. These non-qualified plans are selective and do not have to be offered to all employees. Ordinarily, these plans are used as an incentive to retain, reward, and recruit key and highly compensated employees. These employees often encounter employee benefit limitations and restrictions.

Power of Deferred Compensation

To understand the power of deferred compensation, let's look at the chart below. This example assumes an executive receives a lump-sum amount of \$10,000. If he or she defers the entire amount it will grow to \$46,610 in 20 years with an 8% growth rate. If he or she takes the \$10,000 dollars, the after-tax sum (assumes 40% tax bracket) will be \$6,000. This amount will grow to \$27,966 in 20 years with an 8% growth rate.



Minimal “Red Tape”

Non-qualified deferred compensation plans do not require formal IRS approval and are not subject to qualified plan contribution limitations. However, these plans may be subject to certain ERISA reporting requirements. Non-qualified plans that are not entirely exempt may qualify for limited reporting as “Top Hat” plans. A plan may qualify as a “Top Hat” plan if it is created for the purpose of providing benefits to a select group of management or highly compensated employees. Top Hat plans must be in writing and a description of the plan must be filed with the Department of Labor within 120 days of adoption.

Funding Options for Non-Qualified Deferred Compensation Plans

There are many ways to fund a non-qualified retirement plan. Employers may use a sinking fund, self-fund, annuities or use a life insurance policy. Let’s review each option.

Sinking Fund: The employer sets up a reserve or sinking fund where funds are invested. Benefits are paid from the sinking fund when the employee retires. The employer assumes the market risk and often invests in high-risk assets to meet its future obligations. The employer must pay income taxes on the fund earnings each year and does not have any deductions until the benefits are paid out.



Self-Fund: A self-funded plan is when the employer pays the retirement benefits from the current cash flow. A self-funded plan does not have an immediate impact on the company’s cash flow when established. But there is risk that cash flow will not be available in the future.

Annuities: Under the tax code corporate employers cannot achieve income tax deferral with deferred annuities.

Life Insurance Funding: Funding a deferred compensation plan with life insurance is very popular. In a recent survey conducted by Clark/Bardes Consulting, the survey found that 65% of the employers used life insurance as the funding option for deferred compensation plans.² Life insurance is a popular funding tool because it is cost effective, has tax-deferred accumulations to fund benefits, and the employer can recover all costs with the death benefit proceeds.³

Types of Non-Qualified Executive Benefit Plans

There are four main groups of non-qualified executive benefit plans. These groups are part of two larger sub-groups: defined contribution and defined benefit plans. Defined contribution plans can be financed with either employee or employer money and pay the employee a retirement benefit based upon the value of his or her deferral amount. For instance, the retirement benefit could be the amount deferred growing at a rate tied to an index, such as the DOW or NASDAQ. Defined benefit plans are plans in which the employer agrees to pay a specified benefit in retirement. Below are the subgroups and the type of executive benefits plans in each category.

Contributory Plans

Contributory plans are just that – plans financed with employee money. These are ordinarily defined contribution plans and can be divided into Pure Deferred Compensation Plans, 401(k) Mirror Plans, and Salary Deferral Plans.

Contributory Plans

Pure Deferred Compensation
401(k) Mirror Plans
Salary Deferral Plans

Non-Contributory Plans

Non-Contributory plans are paid for with employer funds and the executive does not have to contribute. These plans are ordinarily defined contribution plans and can be divided into Supplemental Executive Retirement Plans (SERP) and Excess Benefit Plans.

Non-Contributory Plans

Supplemental Executive Retirement Plans
Excess Benefit Plans

Combination Plans

In combination plans, contributions from both the employer and the employee may be used to fund the plan. These plans include Section 162 Executive Bonus Plans, Restrictive Endorsement Bonus Arrangements (REBA), Matching Contribution Plans, and most Split Dollar Arrangements.

Combination Plans

Section 162 Executive Bonus Plans
Restrictive Endorsement Bonus Arrangements (REBA)
Matching Contribution Plans
Split Dollar Arrangements

Death Benefit Plans

Death Benefit plans are employer sponsored plans that may be offered to a particular group of employees. They are usually funded with either universal or term life insurance.

Death Benefit Plans

Group Universal Life
Group Term Carve Out

Salary Deferral Plans

Salary deferral plans are pure contributory plans, which means the entire plan is funded with employee funds, the employer does not contribute. In a salary deferral arrangement, the employee elects to defer part of his or her salary, bonus, or commission until a later date, most likely in retirement. These plans are flexible and unlike qualified plans, they do not have maximum deferral limits and do not have to be offered to everyone.

Advantages of Salary Deferral Plans

Salary deferral plans are beneficial to both the employer and employee.

Employer	Employee
Able to select participants	Solves “reverse discrimination” problem
May co-exist with qualified plans	Tax-deferred growth of assets
Increase competitiveness with “Total Compensation Packages”	Provides an additional source of retirement income ⁴
Minimal set-up cost	Potential unlimited contributions

Supplemental Executive Retirement Plan (SERP)

An employer uses a SERP to provide additional retirement income to a key employee. A SERP is the opposite of a salary deferral plan. It is a non-contributory plan, meaning the employee does not contribute to a SERP, rather the employer is responsible for the funding of the benefit. It is an excellent way for an employer to compensate key employees who are faced with reverse discrimination. The employer has the flexibility to select the employees it wants to participate in the plan, thus increasing retention by rewarding highly compensated employees with a total compensation package.⁵

How does it work?

In a SERP arrangement, the employer and employee enter into an agreement. The agreement states that the employer will pay the employee a certain amount of money either over a period of time or in a lump sum upon death, retirement, or termination of the plan. The income received by the employee is taxable at the ordinary income tax rate and the employer will receive an income tax deduction.

Advantages of SERPs

An excellent way to provide highly compensated individuals with supplemental retirement income.

No cost to the executive

An attractive way to reward select key employees with tax deferred retirement benefits

A great way to provide retirement benefits beyond those provided by qualified plans



A collateral assignment split dollar arrangement is most often used for estate planning purposes. In a collateral assignment arrangement the employee (or the employee's trust) is the owner of the policy. He or she will enter into an arrangement with the employer in which they will use the life insurance policy as collateral for premium payments. The employer does not have access to the policy cash values.⁶

Split Dollar Arrangements

A split dollar arrangement is an agreement between an employer and employee to split a life insurance policy cash value, death benefit and premium payments. Split dollar arrangements have been a popular form of a deferred compensation plan for over 40 years.

Types of Arrangements

There are two primary types of split dollar arrangements, endorsement and collateral assignment. In the business insurance arena the most common type of split dollar arrangement used is the endorsement method. In an endorsement arrangement, the employer is the owner of the policy and a portion of the death benefit is endorsed to the employee. When the employee retires the employer may elect to take distributions from the cash value to provide supplemental retirement benefits.

Type of Arrangements	Owner of Policy	Popular Use
Endorsement	Employer	Deferred Compensation or Key Person Protection
Collateral Assignment	Employee or Trust ⁷	Estate Planning

Advantages of Split Dollar	
Employer	Employee
Low cost	Low cost death benefit protection
Simple to set up	Source of supplemental retirement income
Retains an interest in the policy	Can take it with him or her if the employee leaves the company

Executive Bonus Plans

Executive Bonus Plans, often referred to as Section 162 Bonus Arrangements, are another simple and cost effective way for the employer to provide an employee with supplemental retirement income. In this situation the employer provides a bonus to the employee in the form of a premium payment on a life insurance policy.

How Does it Work?

The employer determines which employees to include in the plan. The employees will apply for life insurance. The employer will provide the employees with a bonus in the form of the premium payments on the life insurance policy. The employee is responsible for paying the income tax due on the bonus. However, the employer may elect to bonus the employee the premium and the income tax amount. This is known as a double bonus arrangement.

At retirement, the employee will be able to use the policy cash value for supplemental retirement income. Moreover, the employee has been provided with permanent life insurance protection for the benefit of his or her family.

Advantages of Executive Bonus Arrangements

Employer	Employee
Simple to install	Death benefit protection
No minimum or maximum employees	Supplemental retirement income
Employer cost may be tax deductible	Can access policy cash value at any time

Restrictive Endorsement Bonus Arrangement (REBA)

A REBA is an Executive Bonus Plan with a restriction on the executive's ability to access the policy cash value for a stated period of time. The REBA agreement typically states that as long as the employee works for the employer, the employer will continue to pay the bonus. These arrangements may also have a vesting schedule. The most popular ones are one-year rolling, five-year rolling, and vesting at retirement.

The employee owns the life insurance policy, but he or she must file a restrictive endorsement with the life insurance company that issues the policy. This arrangement restricts the executive from (1) surrendering the policy cash value (2) taking loans and withdrawals from the policy (3) changing ownership and (4) using the policy as collateral until the arrangement terminates. The employee retains the right to name a beneficiary.

Advantages of a REBA

Employer	Employee
Minimal set up cost	Portable death benefit protection
Selective participation allowed	Source of supplemental retirement income
Encourages employee loyalty	Not subject to qualified plan limits and penalty provisions

Other Business Insurance Applications

In addition to non-qualified plans, there are several other uses for life insurance in the business-planning marketplace. These plans, such as key person insurance, and buy-sell arrangements, most often benefit the employer rather than the employee.

Key Person Insurance

A key person life insurance policy is a policy taken out by an employer on the life of a key employee. This employee can be anyone in the business who is essential to the success and survival of the company. This could be an owner, partner, or an employee whose level of knowledge is invaluable.

How does it work?

In a key person arrangement, the key employee does not have any interest in the life insurance policy. The employer is the owner and beneficiary of the life insurance policy. The purpose of a key person arrangement is to provide the employer with an emergency cash source in case of a sudden and unexpected accident or departure of someone who is vital to the day-to-day operations and long term growth of the business.

Advantages of Key Person Insurance

Employer

Simple to implement

May purchase policies on the lives of several key employees

Has access to potential cash values for emergencies, retirement benefits, and cash flow needs

Buy-Sell Arrangements

Buy-Sell arrangements are plans put into place to help ensure the continuation of a business if one or more owners leave. A well-drafted and properly funded arrangement can protect the interest of the business owners and can facilitate the continuation of the business for years to come.

Type of Arrangements

There are three main types of buy-sell arrangements: (1) Entity Purchase (2) Cross-Purchase and (3) Wait and See Approach. The best type of arrangement is determined based upon the type of business structure and the number of owners. An entity purchase arrangement allows the business to buy out the deceased owners, while a cross-purchase allows the owners to buy each other out. The wait and see approach is a combination of entity and cross-purchase arrangements.

Advantages of Buy-Sell Arrangements

Ensures the business will stay afloat and guarantees the decedent's shares go to the surviving owner and not an outside party.

Life Insurance provides the cash to buy the agreed upon shares.

Several different options allow the businesses to select the right one for them.

Life Insurance in Business Planning

Life insurance has many uses in business planning. It makes providing benefits for key employees simple and hassle free. Life insurance can provide a business with the necessary funds to recruit and/or train a suitable replacement upon the death of a key employee. It can be used by business owners to ensure the continuation of the business upon the death of a key employee or owner. Life insurance can also be used as a way to informally fund non-qualified deferred compensation plans to reward and retain key, highly compensated employees.

Manulife and Business Planning

For the same reasons Manulife is the first choice in estate planning, Manulife should be the first choice for business planning. Manulife offers competitive products, flexible underwriting, and one of the most sophisticated and comprehensive advanced marketing groups in the industry. Manulife also has state-of-the-art illustration systems, such as the MLI SolutionsSM Estate and Business Planning Series. Manulife is on top of the changes in the marketplace to provide you with the best products, services, and support available.

1 Sections 401(k), 403(b), and 457 plans will increase in increments of \$1,000 until 2006. Inflation adjustments will be made in increments of \$500 for post 2006 inflation. Section 401(k) and 403(b) plans have a catch-up provision for individuals over age 50. Please consult your financial advisor for more information.

2 Executive Benefits: A Survey of Current Trends, 2001 Results; Fortune 1000 corporations with 207 responding.

3 In some instances the employer's death benefit proceeds received by a "C" Corporation may be subject to the Alternative Minimum Tax (AMT).

4 Withdrawals and loans taken from life insurance policies classified as modified endowment contracts may be subject to income tax, and may also be subject to federal tax penalty if the withdrawal or loan is taken prior to age 59½. Loans and withdrawals may reduce the death benefit, will reduce the policy cash value, and may cause the policy to lapse. Lapse of a life insurance policy can cause the loss of death benefit and adverse income tax consequences. Depending on the performance of the underlying investment options (in variable policies) there may be more or less than the original amount invested.

5 The cash value of a life insurance contract grows on an income tax-deferred basis. Unlike most other investments, the employer will not pay income taxes on the "fund" that is informally held by the employer to satisfy SERP benefits. This aspect of life insurance makes it an excellent alternative to stocks and mutual funds.

6 IRS Notice 2002-8 has created uncertainty about the taxation of "equity" split dollar arrangements in the future. Consult your legal and tax advisors before entering into any split dollar arrangement.

7 Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds.

This piece is intended to provide an overview of popular business planning concepts and does not discuss all the tax implications of setting up a plan. For more information, please consult your tax advisor. No legal, tax or accounting advice can be given by Manulife Financial and its agents, employees, or registered representatives. The information provided here is merely a summary of our understanding of the current laws and regulations. Prospective purchasers should consult their tax advisor.





www.manulife.com/usinsurance

Manulife Financial and the block design are registered service marks and trademarks of The Manufacturers Life Insurance Company and are used by it and its affiliates including Manulife Financial Corporation.

IM1137 02/02 MLI0312021193